

Part III - Administrative, Procedural, and Miscellaneous

Tax Treatment of Payments Made Under the USDA Peanut Quota Buyout Program

Notice 2002-67

PURPOSE

This notice provides answers to frequently asked questions regarding the tax treatment of federal payments made pursuant to § 1309 of the Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134, 179 (2002) (the Act).

BACKGROUND

Section 1309(a)(1) of the Act repeals the marketing quota programs for peanuts in part VI of subtitle B of title III of the Agricultural Adjustment Act of 1938, as amended (7 U.S.C. §§ 1357-1359a). The repeal is effective May 13, 2002, the date the Act became law.

Section 1309(b)(1) of the Act directs the United States Department of Agriculture (USDA) to offer to enter into a contract with each eligible peanut quota holder for the purpose of providing compensation for the lost value of the quota on account of the repeal. The Act provides for five annual, equal payments of 11¢ per pound of peanut quota to be paid during 2002 through 2006, and does not provide for the payment of any interest. A quota holder also has an option of receiving a single lump sum payment

in any one of those five years, as specified by the quota holder. The contract between a quota holder and USDA will set forth the payment terms selected by the quota holder.

QUESTIONS AND ANSWERS

Q-1. Are the payments received by a quota holder under the Act subject to federal income tax?

A-1. Yes. If the amount paid for the quota is more than the quota holder's adjusted basis in the quota, the quota holder has a taxable gain; if the amount paid for the quota is less than the adjusted basis, the quota holder has a loss that may be deductible for tax purposes. The amount paid for the quota does not include any amount treated as interest for federal tax purposes, and the total amount paid to the quota holder is reduced by amounts treated as interest before determining the quota holder's gain or loss. See Q & A-7 for help in determining whether any portion of the amount paid is treated as interest for federal tax purposes.

Q-2. How does a quota holder determine the adjusted basis of a quota?

A-2. The adjusted basis of a quota is determined differently depending upon how the quota came into the hands of the quota holder.

□ A quota holder who holds a quota that is derived from an original grant by the Federal government of an acreage allotment has a basis of zero in the quota.

□ The basis of a quota that was purchased is the price the quota holder paid for it. The basis of a quota that is derived from an acreage allotment that was purchased is the price that the quota holder paid for the acreage allotment.

□ Generally a quota holder who received a quota as a gift has the same basis in the quota as the person who gave it to the quota holder. Under certain circumstances, the basis is increased by an amount related to the amount of gift tax paid. If the basis is greater than the fair market value of the quota at the time of the gift, the basis for determining loss is that fair market value.

□ The basis of a quota that was inherited is generally is the fair market value of the quota at the time of the decedent's death.

The basis of a peanut quota is not subject to adjustment through amortization, depletion, or depreciation. However, if a quota holder has previously deducted amounts for these purposes, the basis should be reduced by a corresponding amount before determining the quota holder's gain or loss. A similar reduction in the basis of a quota should be made for any amount previously deducted as a loss because of a reduction in the number of pounds of peanuts allowable under the quota. If a quota holder purchased a quota or acreage allotment and deducted the entire cost in the year of purchase, then the quota holder's basis in the purchased quota or the quota derived from the acreage allotment is zero.

Q-3. If a quota holder has a gain and either receives a lump sum payment in the taxable year that includes May 13, 2002, or elects not to use the installment method, when should the gain be included in income for tax purposes?

A-3. The entire gain should be taken into account on the quota holder's federal income tax return for the taxable year that includes May 13, 2002. The amount of gain

to include in income is the excess of the total amount to be received, reduced by any amount treated as interest, over the quota holder's adjusted basis in the quota. See Q & A-7 for help in determining whether any portion of the amount to be received is treated as interest for federal tax purposes.

Q-4. If a quota holder has a gain and reports the transaction using the installment method, when should the gain be included in income for tax purposes?

A-4. The installment method may be used to report a gain if where a quota holder receives at least one payment after the close of the holder's taxable year that includes May 13, 2002. The amount of gain is the excess of the total amount to be received, reduced by any amount treated as interest, over the quota holder's adjusted basis in the quota. Under the installment method, a proportionate amount of the gain is taken into account in each year in which a payment is received. See the instructions for Form 6252, *Installment Sale Income*, for help in determining the amount of gain to take into account. See Q & A-7 for help in determining whether any portion of the amount to be received is treated as interest for federal tax purposes.

Q-5. Is the gain or loss ordinary or capital gain or loss?

A-5. Whether the gain or loss is ordinary or capital depends on how the quota holder made use of the quota.

□ If the quota holder used the quota in the trade or business of farming and, on May 13, 2002, the quota holder's holding period for the quota was more than one year, then the transaction is reported as a section 1231 transaction on Form 4797, *Sales of Business Property*. Assuming a

quota holder has no other section 1231 transactions reportable on Form 4797, any gain is treated as long-term capital gain and any loss is treated as ordinary loss. Even if a quota holder has other reportable section 1231 transactions, the net result of all section 1231 transactions reported is generally either long-term capital gain or ordinary loss. See the instructions for Form 4797 for more detailed information.

□ If the quota holder held the quota for investment purposes, any gain or loss is capital gain or loss. The same result also applies if the quota holder held the quota for the production of income, though not connected with a trade or business.

Under certain circumstances, some or all of the capital gain must be recharacterized and reported as ordinary income. If the quota holder previously deducted (a) the cost of acquiring a quota; (b) amounts for amortization, depletion, or depreciation; or (c) amounts to reflect a reduction in the quota pounds, any resulting capital gain is taxed as ordinary income up to the amount previously deducted. This amount of ordinary income should be included in income in the quota holder's return for the taxable year that includes May 13, 2002, even if the quota holder uses the installment method to report the remainder of the gain.

Q-6. Is the compensation received under the Act self-employment income?

A-6. No.

Q-7. How does a quota holder determine if a portion of the amount paid will be treated as interest for federal tax purposes?

A-7. In the following three situations, no part of the amount paid is treated as

interest for federal tax purposes:

- The total amount paid will not exceed \$3,000;
- All of the payments will be made on or before November 13, 2002; or
- The total amount paid will not exceed \$250,000, and all of the payments will be made on or before May 13, 2003.

In all other cases, there is a possibility that a portion of each payment will be treated as interest for federal tax purposes. Sections 483 and 1274 of the Internal Revenue Code determine whether a portion of a payment is treated as interest and, if so, the amount of interest allocable to a payment. In some cases, even a quota holder that uses the cash receipts and disbursements method of accounting may have to include this interest in income prior to receipt of any payment (for example, if the total payments exceed \$250,000 and the cash method election under § 1274A is unavailable). Except in the three situations described above, therefore, you should consult your tax advisor to determine whether any portion of the amount to be received is treated as interest for federal tax purposes and, if so, when the interest is includible in income.

Q-8. For an individual quota holder, does gain or loss resulting from the exchange of a quota qualify for farm income averaging?

A-8. No. A peanut quota is considered an interest in land, and farm income averaging is not available for gain or loss arising from the sale or other disposition of land.

Q-9. Are the payments under the Act subject to information reporting?

A-9. Yes. Because a peanut quota is considered an interest in land, tSincehe

total amount to be received under a contract generally will be reported by USDA on Form 1099-S for 2002 if the amount is \$ 600 or more. In addition, any portion of a payment treated as interest for federal tax purposes in an amount of \$ 600 or more generally will be reported by USDA on Form 1099-INT for the year in which the payment is made.

Q-10. Is the buyout of the peanut quotas under the Act an involuntary conversion of the quotas?

A-10. No, it is not an involuntary conversion.

DRAFTING INFORMATION

The principal author of this notice is Robert Basso of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding Q & A-7 of this notice, contact Pamela Lew of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622-3950 (not a toll-free call). For further information regarding the remainder of this notice, contact Mr. Basso at (202) 622-4950 (not a toll-free call).